No. 12826

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

LAWRENCE BARKER,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the for the Southern District of California.

BRIEF FOR APPELLANT.

IRELL & MANELLA,
LAWRENCE E. IRELL,
ARTHUR MANELLA,
810 Roosevelt Building,
Los Angeles 17, California,
Attorneys for Appellant.

Parker & Company, Law Printers, Los Angeles. Phone MA. 6-9171.

TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Statutes

MISCELLANEOUS

No. 12826

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

LAWRENCE BARKER,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

BRIEF FOR APPELLANT.

Opinion Below.

The opinion of the District Court [R. 136-138] and its Findings of Fact and Conclusions of Law [R. 140-146] are not officially reported.

Jurisdiction.

This appeal involves an action for the refund of federal income and victory taxes paid by the taxpayer for the calendar year 1943, in the amount of $1,818.98. During the taxable years 1942 and 1943 and at all times since that date taxpayer has been and is a resident of the City of Los Angeles, County of Los Angeles, State of California. [R. 3.] Taxpayer filed his federal income tax return for the calendar year 1943 on March 15, 1944, with the Collector of Internal Revenue of the United States for the 6th District of California at Los Angeles, California, and paid to said Collector the tax liability described on said

return. [R. 5-6.] On March 15, 1947, taxpayer filed with said Collector of Internal Revenue a claim for refund of federal income and victory taxes for the calendar year 1943 in the amount of $1818.98. [R. 4-5, 7-8.] Under date of July 27, 1948, taxpayer was advised by written notice by the Commissioner of Internal Revenue, pursuant to Sec. 3772(a)(2) of the Internal Revenue Code, that said claim for refund had been disallowed in full. [R. 7-8, 17.] On April 22, 1949, taxpayer filed with the District Court of the United States for the Southern District of California, Central Division, a complaint against the United States for refund of 1943 federal income and victory taxes in the amount of said previously mentioned claim for refund, under the provisions of Section 24(20) of the Judicial Code, as amended, and Title 28, United States Code, Section 1346. [R. 3, 8.] On October 24, 1950, the District Court entered judgment in favor of taxpayer against the United States but only in the amount of $434.61 together with interest thereon from March 15, 1944. [R. 146-147.] Notice of appeal was filed by taxpayer on December 18, 1949. [R. 148.] Jurisdiction is conferred on this Court by Title 28, United States Code, Sections 1291 and 1294.

Question Presented.

Where holders of all the common stock of Barker Bros., Inc., of California (California) including the Lawrence Barker Interests, pursuant to a plan, transferred said stock in 1923, to Barker Bros., Inc., of Delaware (Delaware) in exchange for $9,569,700 of Delaware stock; but where as part of the plan, the Lawrence Barker Interests first became contractually obligated to sell and did convey to Marshall Field, Glore, Ward & Co. (Bankers) for cash $2,087,000 of the $9,569,700 of Delaware stock, were the

California stockholders in "control" of Delaware after the transfer so as to constitute the exchange a tax-free one within Section 112(b)(5) of the Revenue Act of 1932?

Statutes and Regulations Involved.

STATUTES.

Internal Revenue Code, Sec. 113, Adjusted Basis for Determining Gain or Loss.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

. . . . . .

(12) *Basis established by Revenue Act of 1932.*—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932, 47 Stat. 199, was prescribed by section 113(a)(6), (7), or (9) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

Revenue Act of 1932, Section 113, Adjusted Basis for Determining Gain or Loss.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

. . . . . .

(6) *Tax-Free Exchanges Generally*—If the property was acquired upon an exchange described in section 112(b) to (e), inclusive, the basis

shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

Revenue Act of 1932, Section 112, Recognition of Gain or Loss.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

. . . . . .

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immedi-

ately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

. . . . . .

(j) *Definition of control.*—As used in this section the term "control" means the ownership of at least 80 percentum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

REGULATIONS.

Treasury Regulations 111, under Internal Revenue Code.

Reg. 111, Sec. 29.113(a)(12)-1. *Basis of Property Establisshed by Revenue Act of 1932.*—Section 113(a)(12) provides that if the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932, was prescribed by section 113(a) (6), (7), or (9) of that Act, then for the purposes of the Internal Revenue Code the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

Treasury Regulations 77, under Revenue Act of 1932.

Reg. 77, Art. 597. *Property acquired upon an exchange.*—In the case of property acquired after February 28, 1913, upon an exchange described in section 112(b), (c), (d), or (e) (see articles 572-577), the basis is the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount

of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made.

. . . . . .

Reg. 77, Art. 572. *Exchanges of property.*—In the following cases no gain or loss is recognized:

(c) If property, real, personal, or mixed, is transferred to a corporation (1) by one person solely in exchange for stock or securities in such corporation, and immediately after the exchange such person is in control of the corporation, or (2) by two or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such persons are in control of the corporation, and the amount of stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. See section 112(j) and article 577 for definition of "control".

Example: A owns a patent right worth $25,000 and B a manufacturing plant worth $75,000. A and B organize the X Corporation with a capital stock of $100,000. A transfers his patent right to the X Corporation for $25,000 of its stock; B transfers his plant to the X Corporation for $75,000 of its stock. No gain or loss is recognized from this transaction.

Reg. 77, Art. 577. *Definitions.*—

. . . . . .

A person is, or two or more persons are, "in control" of a corporation, within the meaning of section 112, when owning—

(1) At least 80 per cent of the voting stock, and

(2) At least 80 per cent of the total number of shares of all other classes of stock of the corporation.

Statement.

Up to and including December 28, 1923, Barker Bros., Inc., a California corporation, hereinafter called California, was engaged in the business of selling furniture and household furnishings in Los Angeles, California. Its outstanding capital stock consisted of 5750 shares of voting preferred stock of a total par value of $575,000, and 17,-894.35 shares of common stock, of a total par value of $1,789,435. Of the 17,894.35 shares of California common stock, 8179.69 shares were owned in varying amounts by Lawrence Barker, as Executor of the Estate of W. A. Barker, deceased, Lawrence Barker, individually (taxpayer herein), Lawrence Barker, trustee, Mrs. W. A. (Pauline) Barker, and F. K. Colby, Trustee, which group of persons is hereinafter referred to as the Lawrence Barker Interests. The remaining shares of common stock of California were owned by a group of persons hereinafter referred to as the C. H. Barker Interests, and by certain employees of California. [R. 22-23.]

In the latter part of 1923, the Lawrence Barker Interests decided to withdraw from participation in the business of California and to dispose of their entire stock interest in that corporation. On October 19, 1923, the Lawrence Barker Interests entered into an agreement with Hunter, Dulin & Co., under the terms of which Hunter, Dulin & Co. was given an option to purchase the California stock owned by the Lawrence Barker Interests for a price per share to be determined by valuing the entire net worth of California at $10,500,000. A verbal understanding had been reached with the C. H. Barker Interests and the employee group that they also would sell their entire stock interest in California to Hunter, Dulin & Co. for

a price to be determined by valuing the entire net worth of California at $10,500,000. [R. 24, 41-44.] Because of the inability of the Lawrence Barker Interests to persuade the C. H. Barker Interests to sell their stock in accordance with the Hunter Dulin & Co. agreement, the option held by Hunter, Dulin & Co. was subsequently relinquished by it upon the payment to it by the Lawrence Barker Interests of $50,000 in cash. The plan later adopted on December 20, 1923, was predicated on the agreement of Marshall Field, Glore, Ward & Co., hereinafter referred to as Bankers, to finance the sale by the Lawrence Barker Interests of their interest in California, but contemplated that the C. H. Barker Interests would retain their interest in the business of California. The Lawrence Barker Interests promised Hunter, Dulin & Co., that if the Bankers' plan did not materialize, the Lawrence Barker Interests would reinstate the original option held by Hunter, Dulin & Co. to purchase their California stock by valuing the entire net worth of that company at $10,500,000, and would give Hunter, Dulin & Co. full cooperation in obtaining in writing the verbal understanding which had been reached with the C. H. Barker Interests and the employee group to effect the sale of their California stock on the same basis, as originally contemplated. [R. 24, 43-44.]

On December 20, 1923, the Lawrence Barker Interests entered into an agreement with the C. H. Barker Interests, under the terms of which the following plan was adopted: A new corporation, Barker Bros., Incorporated, a Delaware corporation, hereinafter called Delaware, was to be organized with an authorized capital stock of $15,000,000, divided into $2,500,000 of First Preferred stock, $2,500,000 of Second Preferred stock, and $10,000,000 par value temporary common stock. Delaware, in exchange

for its par value temporary common stock, would acquire from the Lawrence Barker Interests and the C. H. Barker Interests, together with the employee group, all the common stock of California. The par value temporary common stock of Delaware would be immediately returned to Delaware and replaced by (1) $2,087,000 of Delaware First Preferred stock and $2,300,000 of Delaware Second Preferred stock issued for the California stock transferred to Delaware by the Lawrence Barker Interests, and (2) 100,000 shares of Delaware no par value common stock issued for the California stock transferred to Delaware by the C. H. Barker Interests. Of the $2,087,000 of Delaware First Preferred stock and $2,300,000 of Delaware Second Preferred stock issued by Delaware in exchange for the California stock transferred to Delaware by the Lawrence Barker Interests, $1,087,000 of the First Preferred stock would be sold for cash to Bankers, who would also be given an option to purchase the remaining $1,000,000 of First Preferred stock. Bankers would also purchase from Delaware $413,000 of the latter's remaining unissued First Preferred stock in order to provide Delaware with the funds necessary to redeem the outstanding preferred stock of California, which latter company would then be dissolved and its assets and business taken over by Delaware. The Lawrence Barker Interests were to form another corporation, Lawrence Barker, Incorporated, hereinafter referred to as Securities Company. In exchange for all of Securities Company's stock issued to the Lawrence Barker Interests, Securities Company would receive the $2,300,000 of Delaware Second Preferred stock and also the proceeds from the sale to Bankers of the $2,087,000 of Delaware First Preferred stock to which the Lawrence Barker Interests were entitled by virtue of the transfer to Delaware of their California stock. [R. 24, 45-56.]

As part of the plan, the aforementioned agreement between the Lawrence Barker Interests and the C. H. Barker Interests provided that Delaware would expressly assume all the stockholders' liability of the Lawrence Barker Interests for all the indebtedness of California, and Delaware would indemnify and hold harmless the Lawrence Barker Interests from any and all such liability. [R. 53-54.]

Also on December 20, 1923, the Lawrence Barker Interests and the C. H. Barker Interests entered into an agreement with Bankers. By the terms of this agreement the previously mentioned agreement between the Lawrence Barker interests and the C. H. Barker Interests, setting forth the aforementioned plan, was affirmed. Bankers agreed to purchase for cash $1,087,000 of the Delaware First Preferred stock and were given an option to purchase the remaining $1,000,000 of Delaware First Preferred stock, all of which stock, together with $2,300,000 of Delaware Second Preferred stock, was to be issued as consideration for the California stock transferred by the Lawrence Barker Interests to Delaware. [R. 24-25, 56-63.]

Both of the above mentioned agreements were carried out.

On December 28, 1923, Delaware was organized with an authorized capital stock of 25,000 shares First Preferred stock, 25,000 shares Second Preferred stock, 100,000 shares of temporary Common stock, all having a par value of $100 per share. At its first meeting, on December 28, 1923, the Board of Directors considered and accepted the offers of the holders of all California common stock (17,894.35 shares) to exchange their stock for $9,569,700 par value (95,697 shares) of Delaware temporary Common stock. In accomdance with the terms of these

offers, Delaware temporary Common stock was issued in exchange for the California common stock, as follows:

California Common Stockholders	Number of California Common Shares Exchanged	Number of Delaware Common Shares Issued
C. H. Barker Interests	8,187.69)	43,946.09)
Employee Group	1,300.97)	6,945.91)
Lawrence Barker Interests	8,179.69	43,870.00
J. W. and Martha Beam	226.00	935.00
TOTAL	17,894.35	95,697.00

At the same meeting, Delaware entered into an agreement with the Lawrence Barker Interests whereby in consideration of the transfer to Delaware of the California common stock owned by the Lawrence Barker Interests, Delaware agreed to assume all the stockholders' liability of the Lawrence Barker Interests for the debts of California and to indemnify and hold harmless the Lawrence Barker Interests from any and all such liability. [R. 77-78.]

On the following day, December 29, 1923, the 43,870 shares of Delaware temporary Common stock issued by Delaware for the California stock transferred to it by the Lawrence Barker Interests, were replaced by 20,870 shares of Delaware First Preferred and 23,000 shares of Delaware Second Preferred. [R. 29, 103-105.] Subsequently Bankers acquired for cash 10,870 shares of said Delaware First Preferred stock. [R. 36.] Also, from February 11, 1924 to May 16, 1924, Bankers exercised their option to acquire, and did acquire, the remaining 10,000 shares of said Delaware First Preferred stock. [R. 30-32, 36.] Also on December 29, 1923, the 935 shares of Delaware tempo-

rary Common stock issued by Delaware for the California stock transferred to it by J. W. and Martha Beam were replaced by 935 shares of Delaware Second Preferred stock. [R. 106.]

Also on December 28, 1923, the Lawrence Barker Interests caused Securities Company to be formed. Securities Company, in exchange for all of its stock, issued to the Lawrence Barker Interests, became entitled to receive the proceeds from the sale to Bankers of the 10,870 shares of Delaware First Preferred stock, the remaining 10,000 shares of Delaware First Preferred stock, subject to Bankers' option to acquire the same for cash, and the 23,000 shares of Delaware Second Preferred stock, all of which the Lawrence Barker Interests were entitled to by virtue of their transfer to Delaware of their California stock. [R. 27-29, 84-103.]

On January 5, 1924, Delaware issued to the C. H. Barker Interests and the employee group 100,000 shares of Delaware no par common stock in exchange for its previously issued 50,892 shares of temporary common stock. In February, 1924, California conveyed all its assets to Delaware, subject to all the outstanding liabilities, including the liability for the outstanding preferred stock of California, which Delaware assumed. Thereafter Delaware redeemed all the outstanding preferred stock of California. [R. 33-34.]

On December 28, 1923, the fair market value of the 8179.69 shares of California common stock owned by the Lawrence Barker Interests was $4,387,000, which if apportioned among the 20,000 shares of Securities Company

stock received by the Lawrence Barker Interests equals $219.35 per share. [R. 32.]

On December 28, 1923, the total cost or other basis for determining gain or loss on the sale or disposition of the 8179.69 shares of California common stock owned by the Lawrence Barker Interests was $1,326,081.86. Of said 8179.69 shares, taxpayer individually owned 1841.50 shares having a basis for determining gain or loss of $235,-031.57, which basis if apportioned among the 4504.13 shares of Securities Company stock received by taxpayer (out of a total of 20,000 shares issued to the Lawrence Barker Interests), equals $52.18 per share. [R. 28, 32.]

On December 28, 1943, taxpayer sold, for a price of $5,000, 30 shares of the stock of Securities Company which taxpayer had acquired in 1923, in the transaction above described. [R. 39-40.] Taxpayer included in his 1943 tax return, as income from capital gain, the entire amount of $5,000 received by him as the sale price of his 30 shares of Securities Company stock, thus using a basis of zero for gain or loss upon the sale of such shares. [R. 5-6.]

On March 15, 1947, taxpayer duly executed and filed with the Collector of Internal Revenue for the Sixth District of California a claim for refund of federal income taxes for the calendar year 1943, in the amount of $1,-818.98, alleging, as he does herein, that his basis for gain or loss upon the disposition of 30 shares of Securities Company stock was $219.35 per share, or $6,580.50 for 30 shares, and that no gain, but a loss in the amount of $1,580.50 was therefore realized upon the disposition in 1943 of such 30 shares.

Specification of Errors.

1. The District Court erred in failing and omitting to find as facts all of the facts stipulated by and between the parties and agreed to by and between said parties to be material and relevant, as set forth in paragraphs V, VI, VII, VIII, IX, X, XI, XII, XIII, XIV and XV of the Stipulation of Facts filed by the parties with the Court.

2. The District Court erred in failing and omitting to find as facts all of the facts stipulated by and between the parties as set forth in paragraphs IV, XVI, XVII, XVIII, XIX, XX, XXI, XXII, XXIII, XXIV, XXVI and XXVII of the Stipulation of Facts filed by the parties with the Court.

3. The District Court erred in failing and omitting to find from stipulated evidence establishing the same that the exchange in 1923 by the holders of all the common stock of Barker Bros., Inc., of California, including taxpayer and a group of stockholders associated with him, and the sale to Marshall Field, Glore, Ward & Co. (Bankers) of $2,087,000 of First Preferred stock of Barker Bros., Inc., of Delaware, was done pursuant to the terms of a prior plan and agreements entered into by and between the holders of all of the common stock of Barker Bros., Inc., of California and the banking firm of Marshall Field, Glore, Ward & Co. (Bankers).

4. The District Court erred in finding and concluding as a matter of law that the transaction whereby taxpayer exchanged the shares of common stock in Barker Bros., Inc., of California which he originally owned, for stock in

Barker Bros., Inc., of Delaware, did not give rise to a gain or loss that should be recognized for federal income tax purposes within the meaning of Sections 112(b)(5) and 113(a)(6) of the Revenue Act of 1934. [Conclusions of Law, No. I, R. 144-145.]

5. The District Court erred in failing to find and conclude as a matter of law that the transaction in 1923, whereby taxpayer exchanged the shares of common stock in Barker Bros., Inc., of California which he originally owned, for stock in Barker Bros., Inc., of Delaware, was a taxable exchange upon which gain or loss was recognized for federal income tax purposes within the meaning of Section 112(a) and 113(a) of the Revenue Act of 1932.

6. The District Court erred in finding and concluding that after the exchange by the holders of the common stock of Barker Bros., Inc., of California, for the shares of stock of Barker Bros., Inc. of Delaware, said tranferors were in control of Barker Bros., Inc., of Delaware, with the same proportionate stock interest that they had previously had in Barker Bros., Inc., of California. [Findings of Fact, No. VI, R. 143.]

7. The District Court erred in omitting and failing to find and conclude as a matter of law that after the exchange by the holders of the common stock of Barker Bros., Inc., of California for the shares of stock of Barker Bros., Inc., of Delaware, said transferors were not in control of Barker Bros., Inc., of Delaware, since said transferors did not own at least 80% of the stock of Barker Bros., Inc., of Delaware.

8. The District Court erred in finding and concluding as a matter of law that the 30 shares of the common stock of Lawrence Barker, Incorporated (Securities Company), which taxpayer sold on December 30, 1943, had a cost or other basis for determining gain or loss on their sale or disposition of $52.18 per share, and that taxpayer realized a capital gain of $4,434.60 when he sold said 30 shares for $5,000 on December 30, 1943. [Conclusions of Law, No. II, R. 145.]

9. The District Court erred in failing to find and conclude as a matter of law that the 30 shares of common stock of Lawrence Barker, Incorporated (Securities Company), which taxpayer sold on December 30, 1943, had a cost or other basis for determining gain or loss upon their sale or disposition of $219.35 per share, and that taxpayer realized a capital loss of $1,580.50 when he sold said 30 shares for $5,000 on December 30, 1943.

10. The District Court erred in finding and concluding that taxpayer overpaid his federal income tax for the taxable year 1943 only in the sum of $434.61, and is entitled to have only said amount refunded to him, together with interest thereon as provided by law, from the 15th day of March, 1944. [Conclusions of Law, No. III, R. 145.]

11. The District Court erred in failing to find and conclude as a matter of law that taxpayer overpaid his federal income tax for the taxable year 1943 in the sum of $1,818.98, and is entitled to have said amount refunded, together with interest thereon as provided by law, from the 15th day of March, 1944.

Summary of Argument.

Pursuant to the agreements entered into on December 20, 1923, by and between the Lawrence Barker Interests and the C. H. Barker Interests and Bankers, a plan was adopted which would enable the Lawrence Barker Interests to sell their interest in California and which at the same time would permit the C. H. Barker Interests to retain their interest in California. The above mentioned agreements provided that all of the California common stockholders, including the Lawrence Barker Interests, would transfer their California stock to Delaware, a newly organized corporation. In exchange for said California stock Delaware would issue $9,569,700 of its stock, $4,387,000 of which, in the form of Preferred stock, would be issued for the California stock transferred to Delaware by the Lawrence Barker Interests. As part of said agreements the Lawrence Barker Interests contractually obligated themselves to, and did, transfer to Bankers $2,087,000 of the Delaware Preferred stock. Said $2,087,000 of Delaware preferred stock comprised more than 20 per cent of Delaware's total stock ($9,569,700). The California common stockholders who transferred their California stock to Delaware were therefore not in "control" of Delaware after the transfer, within the meaning of Section 112(b)(5), since they owned less than 80% of Delaware's stock. The exchange thus was not a tax-free exchange, and the basis to the Lawrence Barker Interests of the Delaware stock issued was the cost to them of that stock, *i. e.,* the fair market value, $4,387,000, of the California stock given in exchange therefor. It necessarily follows that the basis of the 20,000 shares of Securities Company stock in the hands of the Lawrence Barker Interests is also $4,387,000, or $219.35 per share.

ARGUMENT.

The 1923 Exchange, Whereby All the Common Stockholders of California Exchanged Their Stock for Stock of Delaware, Was Not a Tax-free Exchange Within Section 112(b)(5) Because Said California Stockholders Were Not in Control of Delaware After the Transfer.

Gain or loss upon the sale, exchange or other disposition of property is determined by the difference between the amount realized therefrom and the basis of such property. (Internal Revenue Code, Sec. 111(a).) It is agreed that taxpayer realized $5,000 from his disposition in 1943 of 30 shares of Securities Company stock. [R. 39-40, 144.] The dispute between the parties herein is concerned solely with the question of what is the basis to taxpayer of such Securities Company stock.

Section 113(a) of the Internal Revenue Code provides that the basis of property "shall be the cost of such property." Normally, an exchange is taxable (Section 112(a) of the Internal Revenue Code), and if stock is received in exchange for property, the cost of the stock is the fair market value of the property exchanged therefor. (*Nathaniel J. Hess v. Commissioner,* 24 B. T. A. 475; *Standard Fuel & Material Co. v. Commissioner,* 29 B. T. A. 51; *United States v. Dickinson,* 95 F. 2d 65 (C. C. A. 1st, 1938); *Helvering v. Williams, et al.,* 97 F. 2d 810 (C. C. A. 2d, 1938); *John Levene v. Commissioner,* T. C. Memo. Op. Aug. 5, 1944, C. C. H. Dec. 14,080(M); *Mertens, Law of Federal Income Taxation,* Vol. 3, Sec. 21.15.) As an exception to the general rule that the basis of property is its cost, Section 113(a)(6) of the Internal Revenue Code (and the Revenue Act of 1932) provides that if property was acquired through a tax-free exchange,

as described in Section 112(b)(5) of the Internal Revenue Code (and the Revenue Act of 1932), the basis of the property received is not cost, *i. e.,* the fair market value of the property exchanged therefor, but rather is the basis of the property exchanged therefor.[1] There is no controversy between the parties as to the correctness of the foregoing legal propositions.

In the instant case it is stipulated that on December 28, 1923, the cost or other basis to taxpayer of the 1841.50 shares of California stock transferred by him to Delaware for a portion of the $4,387,000 of Delaware stock issued by the latter corporation in exchange for all of the California stock transferred to it by the Lawrence Barker Interests, was $235,031.57.[2] [R. 32.] The lower court concluded that the 1923 exchange, whereby all of the common stockholders of California exchanged their stock for Delaware stock, was a tax-free exchange within the meaning of Section 112(b)(5), on the ground that said California stockholders were in control of Delaware immediately following the exchange with the same proportionate stock interests that they had previously held in California.

---

[1]Since the taxpayer acquired his L. B. Inc. shares in a 1923 transaction, Section 113(a)(12) of the Internal Revenue Code provides that his basis for those shares shall be the basis prescribed in the Revenue Act of 1932. However, Section 113(a), Section 113(a)(6), and the relevant portions of Section 112(a) and (b) of the Revenue Act of 1932 are identical to the same numbered sections of the Internal Revenue Code. The same is true with respect to the Revenue Act of 1934, to which the lower Court referred.

[2]The Lawrence Barker Interests transferred to Delaware 8,179.69 shares of California common stock, for which Delaware issued $2,087,000 of its First Preferred stock and $2,300,000 of its Second Preferred stock. The total cost or other basis to the Lawrence Barker Interests of said 8,179.69 shares of California stock was $1,326,081.86, of which taxpayer owned 1,841.50 shares, having a cost or other basis of $235,031.57. [R. 32.]

The court thus determined that the basis to the taxpayer of his California stock, *i. e.*, $235,031.57, should be carried over to the Delaware stock issued in exchange therefor and also to his Securities Company stock, thus resulting in a basis of $52.18 for each share of Securities Company stock received by the taxpayer. [R. 143-145.]

It is also stipulated in the instant case that on December 28, 1923, the fair market value of the 8179.69 shares of California common stock transferred by the Lawrence Barker Interests, including taxpayer, to Delaware for $4,387,000 of the latter's stock was $4,387,000. [R. 32.] If, as taxpayer contends, the 1923 exchange, whereby all the common stockholders of California exchanged their stock for Delaware stock, was not a tax-free exchange within the meaning of Section 112(b)(5) because the California stockholders were not in control of Delaware immediately after the transfer, then the basis to the Lawrence Barker Interests of said Delaware stock is the cost to them of such stock, i. e., $4,387,000. In such event, the basis of the 20,000 shares of the Securities Company stock issued to the Lawrence Barker Interests, including taxpayer, would likewise be $4,387,000, or $219.35 per share.

The issue for determination therefore is whether, after the 1923 exhange whereby all the common stockholders of California exchanged their stock for 95,697 shares of Delaware stock, said California stockholders were in "control" of Delaware so as to constitute the transaction a tax-free exchange within the meaning of Section 112(b)(5).

Section 112(b)(5) of the Revenue Acts of 1932 and 1934 provides:

> *"Transfer to corporation control by transferor.*—No gain or loss shall be recognized if property is

transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange . . ."

Section 112(j) of the Revenue Act of 1932, and 112(h) of the Revenue Act of 1934, provides:

> *"Definition of control*—As used in this section, the term "control" means the ownership of at least 80 percentum of the voting stock and at least 80 percentum of the total number of shares of all other classes of stock of the corporation."

On December 28, 1923, all the California common stockholders, including the Lawrence Barker Interests, transferred their 17,894.35 shares of California stock to Delaware. In exchange therefor, Delaware issued its stock as follows: $2,087,000 of First Preferred stock (20,870 shares) and $2,300,000 of Second Preferred stock (23,000 shares) for the 8,179.69 shares of California stock transferred by the Lawrence Barker Interests; $5,089,200 of common stock (50,892 shares) for the 9,488.66 shares of California stock transferred by the C. H. Barker Interests and Employee Group; and $93,500 of Second Preferred stock (935 shares) for the 226 shares of California stock transferred by J. W. and Martha Beam. At that moment,

Delaware had outstanding total stock in the amount of $9,569,700.[3]

Before it can be said that the exchange by all of the California common stockholders of their California stock for Delaware stock was a tax-free exchange within the meaning of Section 112(b)(5), it is necessary to conclude that such stockholders owned at least 80% of the stock of Delaware. (See Sections 112(b)(5) and 112(j) of the Revenue Act of 1932.) However, the Lawrence Barker Interests, under their contract of December 20, 1923, with Bankers, were contractually obligated to sell to Bankers the entire amount of the $2,087,000 of Delaware First Preferred stock. $1,087,000 of said First Preferred stock was conveyed to Bankers for cash immediately, and the balance of $1,000,000 of First Preferred stock was conveyed to Bankers for cash pursuant to the exercise by Bankers of the option which had previously been granted Bankers by the Lawrence Barker Interests. Since the Lawrence Barker Interests, as part of the original plan and agreements, were obligated to sell to Bankers said $2,087,000 of Delaware First Preferred stock, and since said stock comprised more than 20% of the total outstanding stock of Delaware (20% of $9,569,700 equals $1,913,940), it cannot be said that after the transfer the California stockholders as transferors were in "control" of Delaware through the ownership of more than 80% of the stock of Delaware.

An examination of the pertinent authorities will demonstrate the correctness of taxpayer's position.

---

[3]On January 3, 1924, Delaware authorized the issuance of an additional 413,000 of its First Preferred stock to Bankers, all in accordance with the December 20, 1923, agreement previously entered into with Bankers. Said stock was thereupon issued to Bankers. [R. 30, 121-122.]

In *Bassick v. Commissioner,* 85 F. 2d 8 (C. C. A. 2d 1936), cert. den. 299 U. S. 592, the taxpayers, as stockholders of the Bassick Company, in January, 1923, entered into an agreement with Central Securities Company whereby a new corporation, Bassick-Alemite Corporation, would be formed with an authorized capital of 200,000 shares of no par common stock. The Central Securities Company, having acquired the right to 5000 shares of stock of the Bassick Manufacturing Company, agreed to transfer said shares to the new company for 52,500 shares of stock of the new corporation. The taxpayers agreed to transfer to the new corporation their stock in the Bassick Company in exchange for the remaining 147,500 shares of the new corporation's stock, plus notes. At the same time, the taxpayers obligated themselves to sell 65,000 of said 147,500 shares for $1,300,000. The above steps were carried out in February of 1923. The taxpayers contended that the transfer by them of their stock in Bassick Company for the stock of the new company, Bassick-Alemite Corporation, was a tax-free exchange within Section 202(c)(3) of the Revenue Act of 1921, the provisions of which were identical to that of Section 112(b)(5) of the Revenue Acts of 1932 and 1934. The Second Circuit Court of Appeals, however, held that the transaction was not a tax-free exchange because of the fact that the taxpayers, even though originally receiving 147,500 shares of the stock of Bassick-Alemite Corporation, were obligated to transfer 65,000 of these shares, as part of the plan, and therefore could not be said to be in "control" of the transferee company immediately after the exchange. The Court declared:

> "When the Bassick-Alemite Corporation transferred the 147,500 shares to Bassick, it had not yet issued its remaining common stock, so that Bassick

was then the owner of 100% of the outstanding shares. He sold, as he was under obligation to sell, 65,000 of these shares to the Central Securities Company as part of the same transaction. Further, as part of the same plan, the Bassick-Alemite Corporation was then obligated to and did transfer to the Central Securities Company, the remaining 52,500 shares of its authorized no par common stock in exchange for the 5,000 shares of the Bassick Manufacturing Company stock held by the Central Securities Company. If either of these facts be given weight, Bassick and the stockholders he represented, were not 'in control' of the Bassick-Alemite Corporation, since he would not own 80 per centum of the transferee corporation 'immediately after the transfer.'

* * * * * * * *

"It is further to be noted that the stockholders were bound before the receipt of the 147,500 shares to sell 65,000 to the Central Securities Company. These shares were never delivered to the Bassick Company shareholders; Bassick deposited them with a trust company for delivery according to the prearranged plan, for $1,300,000.00. This fact, as well as the fact that Bassick-Alemite had not been effectively organized at the date the petitioner would have us consider would be sufficient to hold that this sale did not come within Section 202(c)(3) of the Revenue Act of 1921."

In the case of *Schumacher Wall Board Corp. v. Commissioner,* 93 F. 2d 79 (C. C. A. 9th, 1937), this Court reached the same conclusion as the Second Circuit Court of Appeals had reached in the *Bassick* case. In the *Schumacher* case, Hunter, Dulin & Co., in 1926, as the owner of all of the stock of the old corporation, entered into an

agreement which contemplated the following: all the assets of the old corporation would be conveyed to a new corporation (taxpayer) in exchange for all of the stock of the new company, *i. e.,* 59,990 common shares and 30,000 preferred shares. Hunter, Dulin & Co. would obligate themselves to transfer for cash 49,075 shares of the common stock of the new company to three ultimate transferees, who previously had had no interest in the old company. The plan was carried out. The issue involved was whether, as the government contended, the provisions of Section 113(a)(7) of the Revenue Act of 1928 were applicable in determining the basis of the transferred assets in the hands of the corporation. That section, which contained language similar to that in Section 112(b)(5) of the Revenue Acts of 1932 and 1934, provided that in the case of transferred property, the property in the hands of the transferee should have the same basis as it would in the hands of the transferor if "immediately after the transfer an interest or control in such property of 80 per centum or more remained in the same persons or any of them." This Court concluded that even though all of the stock of the new company had originally been issued to Hunter, Dulin & Co., since Hunter, Dulin & Co., as part of the plan, was obligated to transfer more than 20 per cent of such stock to other persons, it could not be said that "immediately after the transfer an interest or control * * * of 80 per centum or more remained in the same persons or any of them." Judge Denman, speaking for a unanimous court, said:

> "In the light of uncontradicted evidence in the record, showing that Hunter, Dulin & Co. was, previous to the transfer of assets, bound by contract to convey to the three ultimate transferees the bulk of the taxpayer's common stock received from the old company,

we interpret this finding of 'the general plan' to include this contractual obligation.

"* * * immediately after the transfer of assets, Hunter, Dulin & Co., pursuant to contract with the transferor corporation, received stock of the taxpayer in excess of 80 per cent controlling interest; *that at the instant of receiving this new stock,* Hunter, Dulin & Co. was bound by contract to convey the greater part of it to the three ultimate transferees; and that, in pursuance of this obligation, it did so transfer the new stock.

"On these facts the Commissioner urges that the instant before and the instant after the transfer of asests from the old corporation to the taxpayer, an interest of 80 per cent or more remained in the same person or persons, namely, Hunter, Dulin & Co., and that hence the basis of gain, loss, and depreciation under the statute, is the same as it would have been in the hands of the old corporation.

"Conceding, as it must, this momentary continuation of an interest of over 80 per cent in Hunter, Dulin & Co., the taxpayer argues that due to the series of contractual obligations by which Hunter, Dulin & Co., had previously bound itself, first, to acquire the stock of the old company, then to accept the stock of the new, and, lastly, to transfer the majority of the new stock to three other concerns, the series of transactions must be viewed as a unit, and the ownerships of 80 per cent compared at the beginning and end of the consummation of the entire plan. In this view of the case, Hunter, Dulin & Co. did not retain sufficient control to bring the situation within the statute.

"The Board adopted the taxpayer's contention, holding that 'the question of control is to be determined by the situation existing at the time of the comple-

tion of the plan rather than at the time of the fulfillment of one of the intermediate steps.'

"We agree with the holding of the Board.

* * * * * * * *

"It is squarely within our decision in *Halliburton v. Commissioner* (CCA-9), 78 Fed. (2) 265, 267 * * *. The two taxpayers in that case were sole members of a partnership engaging in oil well cementing. Taxpayers entered into a contract with seven oil companies, which contract provided for the formation of a new corporation to take over the assets and business of the partnership. The new corporation was to have an authorized capital stock of 3,500 shares, of which the taxpayers were to have 1,780 and the oil companies 1,300. When the assets of the partnership were transferred to the new corporation, the taxpayers received their 1,780 shares. It was not until 22 days later that the remaining 1,300 shares were issued to the oil companies, as provided in the contract. Therefore, during the interim, the taxpayers held the entire outstanding stock of the corporation. We held that notwithstanding this ownership, the pre-existing contractual arrangement negatived the proposition that an 80 per cent interest or control remained in the transferor taxpayers.

"Equally conclusive of the present appeal are *Hazeltine Corporation v. Commissioner* (CCA-3), 89 Fed. (2) 513, 518, Bassick v. Commissioner (CCA-2), 85 Fed. (2) 8, 10 (cert. den. 299 U. S. 535), and *Von's Co. v. Comm.* (CCA-9), No. 8154, Nov. 24, 1937."

As noted by this Court in the *Schumacher* case, the same conclusion had been previously reached by the Third Circuit Court of Appeals in *Hazeltine Corp. v. Commissioner,*

89 F. 2d 513 (C. C. A. 3d, 1937), the facts of which were almost identical to those in the *Schumacher* case. In the *Hazeltine* case, the Hazeltine Research Corporation entered into a contract with the investment firm of Foster, McConnell & Company, pursuant to which assets of the former company were transferred to a new corporation (taxpayer) in exchange for more than 80 per cent of the new corporation's stock, *i. e.,* 155,250 shares. At the same time Hazeltine Research Corporation obligated itself to transfer to the investment firm 135,000 shares of the new company. The issue for determination was the basis of the transferred assets in the hands of the new company. The Third Circuit Court of Appeals stated that "The determination of this question in turn depends, under Section 113(a)(7) and 112(b)(5) of the Revenue Act of 1928, upon whether immediately after the transfer on February 19, 1924, Hazeltine Research Corporation retained 80 per cent control of the stock of the petitioner." It then concluded that since "the transaction must be viewed as a whole," and since the Hazeltine Research Corporation was obligated to transfer to the investment company stock of the petitioner in an amount which left the Hazeltine Research Corporation with less than 80 per cent of the petitioner's stock Hazeltine Research Corporation did not have control of the petitioner immediately after the transfer within the meaning of Sections 113(a)(7) and 112(b)(5) of the Revenue Act of 1928.

The United States Court of Claims has also unanimously reached the same conclusion set forth in the previously discussed cases. In *National Rubber Machinery Co. v. United States,* 38 Fed. Supp. 260 (C. Cl. 1941), the taxpayer, a newly organized corporation, pursuant to a previously agreed upon plan, issued all of its stock (82,080

shares) to six corporations which transferred property to it in exchange therefor. The government contended that the basis to the taxpayer of the properties acquired, was determined by Sections 113(a)(7) and 113(a)(8) of the Revenue Act of 1928, both of which sections required as a condition of their applicability that immediately after the transfer the transferors be in control of the transferee through the ownership of not less than 80 per cent of its stock. Pursuant to a previous decision[4] the government conceded that in determining whether the transferors owned 80 per cent of the stock of the transferee, there was to be ignored 4,000 shares issued to one of the transferors, *i. e.,* The Banner Machine Company, *"because of the fact that prior to its receipt of these shares the Banner Machine Company had entered into a binding option to sell them and because the option was later exercised and the shares were in fact sold."* (Italics supplied.) It argued, however, that even without the 4,000 shares originally issued to the Banner Machine Company, the transferors others than the Banner Machine Company owned more than 80 per cent of the transferee corporation's stock. However, the United States Court of Claims found that one of said other transferors (J. A. Sisto & Co.) had also entered into a binding obligation to sell the shares issued to it and had in fact so sold them. As a result, the Court, relying on this Court's decision in the *Schumacher Wall Board* case, concluded that the original transferors, being left with less than 80 per cent of the stock of the transferee corporation, were not therefore in control of it immediately after the transfer.

---

[4]See *Banner Machine Co. v. Routzahn,* 107 F. 2d 147 (C. C. A. 6, 1939), cert. den. 309 U. S. 676, reh. den. 310 U. S. 656.

See also,

Columbia Oil & Gas Co. v. Commissioner, 41 B. T. A. 38, aff'd 118 F. 2d 459 (C. C. A. 5th, 1941);

Heberlein Patent Corp. v. United States, 105 F. 2d 965 (C. C. A. 2d, 1939).

In the instant case, it must be remembered that from the outset of the proceedings begun in the latter part of 1923, it was the intention and desire of the Lawrence Barker Interests to withdraw completely from participation in the business of California and to dispose of their entire common stock interest in that corporation for cash. The original agreement of October 19, 1923, with Hunter, Dulin & Co., giving the latter the option to buy the California stock of the Lawrence Barker Interests for a price per share to be determined by valuing the entire net worth of California at $10,500,000, was designed to accomplish that objective. [R. 41-43.] The Hunter, Dulin & Co. agreement had to be abandoned because of the inability of the Lawrence Barker Interests to persuade the C. H. Barker Interests also to sell their California stock to Hunter, Dulin & Co., as the C. H. Barker Interests had previously verbally agreed to do. [R. 43-44.] Thereupon negotiations were immediately begun with Marshall Field, Glore, Ward & Co. (Bankers) to develop a plan which would enable the Lawrence Barker Interests to sell their interest in California and which at the same time would permit the C. H. Barker Interests to retain their interest in the business of that company. The agreements of December 20, 1923, by and between the Lawrence Barker Interests and the C. H. Barker Interests and Bankers, were entered into for the purpose of accomplishing that result. Such result was in fact accomplished by the plan adopted. The Lawrence Barker

Interests were relieved of all stockholders' liability for the debts of California, and were enabled to convert their common stock interest in California into cash from the disposition to Bankers of $2,087,000 of Delaware First Preferred stock. The C. H. Barker Interests, who were not relieved of their stockholders' liability for the debts of California, were permitted to retain their common stock interest in the business of California by becoming common stockholders in Delaware, the company which succeeded to the business of California.

In view of the clear state of the record as to what the parties intended to, and did, accomplish, and in view of the judicial authorities previously cited, together with the stipulated fact that as part of the original plan the Lawrence Barker Interests were contractually obligated to, and did, transfer to Bankers the $2,087,000 of Delaware First Preferred stock issued for their California stock (which Delaware stock comprised more than 20 per cent of Delaware's total stock), it is difficult to understand how the lower court could have concluded that the exchange by the California stockholders of their California stock for Delaware stock was a tax-free exchange within Section 112(b)(5). Perhaps the issues of the case were not as narrowly defined in the lower court, and this may have prompted the judge to state with respect to his study of the authorities cited in counsels' briefs that "To me it was like going through a terrible nightmare." [R. 138.][5]

---

[5]The trial judge, in noting the relatively small amount of tax claimed for refund in the present proceeding, questioned the "expense and work devoted" by counsel to the case. [R. 136.] Obviously, however, since the ultimate decision herein will determine whether the Lawrence Barker Interests have a basis for their stock of $4,387,000 or only $1,326,081.86, the case justifies considerable expense and work.

As taxpayer has demonstrated herein, the transfer to Delaware by the California stockholders of their California stock for the issuance of $9,569,700 of Delaware stock was not a tax-free exchange within Section 112(b)(5), for the reason that the Lawrence Barker Interests, as part of the originally adopted plan, were contractually obligated to, and did in fact, transfer to Bankers $2,087,000 of Delaware First Preferred stock, thus leaving the California stockholders with less than 80 per cent of Delaware's stock after the transfer and, therefore, not in "control" of that company. Since the exchange by the California common stockholders of their California stock for Delaware stock was not a tax-free exchange within Section 112(b)(5), the basis to the Lawrence Barker Interests of the Delaware stock issued was the "cost" of that stock, *i. e.,* the fair market value, $4,387,000, of the California stock given in exchange therefor. It necessarily follows that the basis of the 20,000 shares of Securities Company stock in the hands of the Lawrence Barker Interests is also $4,387,000, or $219.35 per share.

Conclusion.

The decision of the District Court is incorrect and should be reversed.

Respectfully submitted,

IRELL & MANELLA,
LAWRENCE E. IRELL,
ARTHUR MANELLA,
Attorneys for Appellant.

March, 1951.